



Annual Report on Method & Rationale for Product Pricing

As Prescribed by Act 39 of 2016



March 30, 2023



COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA LIQUOR CONTROL BOARD
Northwest Office Building
Harrisburg, Pennsylvania 17124-0001

March 30, 2023

The Honorable Mike Regan
Majority Chairman
Senate Law & Justice Committee
171 Main Capitol Building
Harrisburg, PA 17120

The Honorable James Brewster
Minority Chairman
Senate Law & Justice Committee
458 Main Capitol Building
Harrisburg, PA 17120

The Honorable Daniel Deasy
Majority Chairman
House Liquor Control Committee
304 Irvis Office Building
Harrisburg, PA 17120

The Honorable Mindy Fee
Minority Chairwoman
House Liquor Control Committee
43 East Wing
Harrisburg, PA 17120

Chairmen Regan, Brewster and Deasy, and Chairwoman Fee:

Enclosed is the Pennsylvania Liquor Control Board's (PLCB) Annual Report on Method and Rationale for Product Pricing as required by Act 39 of 2016.

In 2022, COVID-19 pandemic-related disruptions in the beverage alcohol industry began to recede and market dynamics started to normalize; however, new challenges from the impact of persistent inflation on our suppliers, customers and agency operations have again proven the adage that the only constant is change.

This report details the PLCB's pricing practices and processes throughout calendar year 2022. As in past years, we specifically detail the historical background of the agency's statutory pricing authority, the methodology that guides product selection and retail pricing decisions, and data regarding our product portfolio and retail price adjustments. Lastly, we include a forward-looking assessment of our plans for the remainder of the calendar year.

We hope this report is informative to the members of the Senate Law and Justice and House Liquor Control Committees.

Sincerely,

Tim Holden
Chairman

Mary Isenhour
Board Member

Randy Vulakovich
Board Member

STATUTORY PRICING REQUIREMENTS

Historical Background

The pricing structure for wine and spirits sold by the PLCB has evolved throughout the history of the agency. The Liquor Code authorizes the PLCB to establish the prices for the alcohol products that it sells. The retail price is the shelf price paid by individual customers at Fine Wine & Good Spirits (FW&GS) stores and online at FWGS.com. Certain licensees receive a statutorily established 10% discount off the retail price.

Prior to the pricing reforms included in Acts 39 and 85 of 2016, section 207 of the Liquor Code mandated that retail prices had to be proportional with prices paid by the PLCB to its suppliers. This provision required the agency to use a proportional markup to price products. The PLCB's markup structure, prior to the enactment of Acts 39 and 85, consisted of two straight percentage markups (a 1%, then a 30% markup), as well as a handling fee called the logistics, transportation and merchandising factor (LTMF). Subsequently, the 18% liquor tax was applied and then the price was rounded to determine the retail shelf price.

The uniform markup structure prevented any consideration of product supply and demand or other marketplace factors in the PLCB's pricing decisions. Consequently, a mass-market chardonnay had the same markup as a highly sought-after limited-release bourbon. The proportional markup also allowed suppliers to set the retail price of products and maximize their margin by using the markup structure to work backward to calculate their product acquisition cost to the PLCB.

The PLCB did have the authority to set the markup, and it varied throughout the history of the agency. Prior to the enactment of Act 39, the 30% markup had not changed in more than two decades.

Pricing Reforms Under Acts 39 and 85 of 2016

Act 39 significantly modified the PLCB's pricing authority. Specifically, section 207 of the Liquor Code was amended to allow the agency to "price its best-selling items and limited purchase items in a manner that maximizes the return on the sale of those items" and to "discount the price of discontinued items." Limited purchase items include products "that the Board purchases on either a one-time or nonrecurring basis due to the product's limited availability or finite allocation," and discontinued items include products the PLCB "has voted to delist at a public meeting." Subsequently, Act 85 of 2016—which amended the Fiscal Code but contained provisions impacting the Liquor Code—defined "best-selling items" as "the 150 most sold brands and product types of wine and the 150 most sold brands and product types of liquor as measured by the total number of units sold on a six-month basis calculated every January 1 and July 1." The expanded pricing authority authorized by Acts 39 and 85 is commonly referred to as "flexible pricing." The PLCB is required to sell products, except for items offered through a customer relations

management program, at the same retail price across Pennsylvania. All wine and spirits products sold by the PLCB remain subject to the 18% liquor tax, which is included in the product's retail shelf price. This liquor tax is transferred to the General Fund and does not support the PLCB's operations or annual cash transfers to the General Fund.

The PLCB's special order (SO) portfolio, which includes approximately 50,000 specialty items that are not stocked in FW&GS stores or licensee service centers, is not subject to flexible pricing. However, Act 39 did alter the pricing structure for these products. The markup on SO products was reduced from 30% to 10%. The pricing structure for SO products that are delivered to FW&GS stores includes the LTMF. SO products that are directly delivered to customers are not assessed the LTMF. As established by statute, SO products are not eligible for the 10% licensee discount. Licensees generally account for 98% to 99% of total SO sales annually.

METHODOLOGY & RATIONALE

The PLCB's priorities related to product selection and pricing remain unchanged from previous years. The agency seeks to offer a wide assortment of quality products that reflect marketplace trends while providing our customers with value and opportunities to discover new and innovative items. Additionally, the PLCB is committed to fulfilling its unique financial responsibilities to support the Commonwealth's General Fund through our annual cash transfers and to provide funding to various state, local and industry beneficiaries. A balanced approach to these two goals drives our product merchandising strategy and our relationships with suppliers.

Product Portfolio

The below chart reflects the listed portfolio for Calendar Year (CY) 2022:

	Item Count	Dollar Sales	Unit Sales
Listed Spirits	2,492	\$1,696,368,370	100,648,601
Listed Wine	3,008	\$877,281,832	69,121,000
Total	5,500	\$2,573,650,202	169,769,601

The below chart reflects the luxury and Chairman's Selection® portfolios for CY 2022:

	Item Count	Dollar Sales	Unit Sales
Luxury Spirits	791	\$31,780,744	558,525
Luxury Wine	4,574	\$81,489,234	4,152,514
Chairman's	331	\$56,948,716	4,642,547
Total	5,696	\$170,218,694	9,353,586

Product Evaluation & Negotiation Process

The PLCB generally purchases wine and spirits products as either a regular stock listing (listed portfolio) or one-time buy (luxury and Chairman's Selection® portfolios). Each portfolio, as well as the product categories within those portfolios, are designed to provide a wide selection of items that caters to the diverse preferences of our retail and wholesale customers.

The listed portfolio consists of the most common and popular wine and spirit items across the state. Listing proposals from suppliers are generally reviewed twice a year. New submissions for regular stock listed products are initially assessed based on the category roles assigned to each marketing group and price segment. Suppliers with items that pass this initial evaluation are asked to submit a product sample for review. Suppliers with items that perform well in the sample review are asked to give a presentation to the PLCB's product category managers.

The Bureau of Product Management uses a variety of market-based criteria to assess products. Some of these metrics include current and historical category sales data, price and segment growth trends, a quality-to-value proposition, product innovation and supplier-proposed marketing support. Additionally, consideration is given to how an item would contribute to the current product portfolio. For example, segment underrepresentation, line or size extension of a successful brand, customer trade-up opportunity and other factors are all considered. Marketing support and sales data for new listed products is periodically reviewed to identify, and potentially delist, underperforming items.

The luxury and Chairman's Selection® product portfolios are purchased on a one-time-buy basis, so each purchase order for these products represents a new negotiation with the supplier. Consequently, the PLCB can leverage its buying power and significant relationships with wineries, distilleries and suppliers all over the globe to purchase high-quality wine and spirits. Luxury wine and spirits are reviewed throughout the year.

To participate in the Chairman's Selection® program, a supplier must provide a minimum 35% discount from a nationally quoted or retail price. Every wine that makes it into the program is evaluated for quality and offers compelling value to our customers.

For all products in the listed, luxury and Chairman's Selection® portfolios, the PLCB negotiates product acquisition costs with suppliers and establishes retail prices by considering a variety of financial metrics together with market-based criteria. For example, gross margin potential, gross margin percentage relative to comparable items within the category, manufacturer's suggested retail price and the impact of key threshold price points on sales are all considered during the negotiation process.

The PLCB uses a multi-tiered review process to establish product acquisition costs and retail prices for wine and spirits. Category managers initially negotiate product acquisition costs and retail prices with suppliers. Subsequently, these recommendations are reviewed by the division chief, director of product selection, chief merchandising officer, executive director and, finally, the three-

member Board. A pricing coordinator also evaluates pricing decisions across various categories and portfolios to ensure consistency in the agency’s pricing practices.

In conformity with Act 39 of 2016, [quarterly product price lists](#) dating back to October 2016 are posted at lcb.pa.gov under the News/Reports section. Current retail prices can be viewed at FWGS.com.

Retail Price Adjustments & Promotional Sales Events

The below chart details item product acquisition cost and item retail price changes during CY 2022:

	<i>Cost</i>		<i>Retail</i>	
	Increases	Decreases	Increases	Decreases
Regular Changes	509	17	506	13
PSE Changes	376	2,210	373	14
Total	885	2,227	879	27

In 2022, the PLCB continued implementation of its promotional sales event (PSE) program, which began in late 2021. PSEs are a new process for administering temporary sale pricing. Historically, the sale prices offered in FW&GS stores and online (\$1/\$2/\$3/etc. off regular price) were funded by suppliers through special pricing allowances (SPAs). Under the SPA program, a supplier reimbursed the PLCB after agency sales to customers were tallied at the completion of the sale period. To ensure compliance with federal law, the PLCB created a new approach that enables the agency to fund sale prices by negotiating lower product acquisition costs with suppliers inclusive of the temporary price discounts they offered previously under the SPA program. While the PLCB ultimately controls the timing of sale pricing under PSEs, the agency works with suppliers to coordinate PSEs with their product marketing plans. Regardless of these administrative and accounting changes, retail customers and licensees continue to enjoy hundreds of product sales each month.

The implementation of the PSE program created a significant increase in the number of cost and retail price adjustments during 2022. Previously, SPAs did not impact product acquisition costs since they were funded on a reimbursement basis. Consequently, the CY 2022 price adjustment data separates the PSE changes from regular changes to product acquisition costs and retail prices. Some items had more than one price change during the calendar year and are therefore counted more than once in the tally. Several hundred of the PSE changes represent the same product changing prices more than once.

During the past two years, likely due to record inflation, suppliers have sought an increased number of product acquisition cost increases. As reflected in the 2022 regular changes data, product acquisition cost increases from suppliers generally resulted in retail price increases by the PLCB to preserve the agency’s gross margin. When considering a retail price increase based on a product acquisition cost increase, the agency reviews many factors including current gross margin,

comparison of gross margin percentage to category peers and the impact of a key threshold price point on unit sales. Small increases in product acquisition costs by suppliers sometimes do not result in retail price changes by the PLCB.

January 2023 Retail Price Increase

While not reflected in the CY 2022 data in this report, the PLCB did increase retail prices by about 4% on 3,554 items effective Jan. 15, 2023. The retail prices of an additional 397 items that were on sale during January were increased by about 4% effective Jan. 30. These products included the most popular and commonly available wines and spirits in FW&GS stores. The price increase did not include approximately 5,600 one-time buys (seasonal and luxury items), 2,700 items on clearance, 100 PA Proud items in 10 or fewer FW&GS stores and all SO products.

Recognizing the economic pressure faced by our retail and wholesale customers throughout the COVID-19 pandemic and subsequent supply chain disruptions, the PLCB had not initiated retail price increases since 2019. During that time, the agency only passed along supplier-driven product acquisition cost increases, which are reviewed on a quarterly basis.

Although the PLCB is a state-run enterprise, the agency is not immune from the persistent inflationary environment that has similarly impacted manufacturers and retailers across the globe. Operational expenses related to personnel, distribution, leases, credit card fees and other costs have increased significantly. While the agency works diligently to constrain expenses, some costs are outside of the PLCB's control.

The across-the-board increase on retail prices continues the agency's commitment to using flexible pricing in a fair and consistent manner that does not favor any single supplier, product or customer.

Limited-Release Lotteries

In the case of certain limited-availability, highly sought-after products, supply simply cannot meet demand. To most fairly distribute the small quantity of highly allocated products—such as certain bourbons—that the agency receives from suppliers, the PLCB uses a lottery process to give licensees and Pennsylvania residents the opportunity to purchase these highly desirable items. Lottery drawings are witnessed by an independent third party and use a computer program to randomly select winners.

In 2022, Limited-Release lotteries were held in January, June and November. These lotteries attracted hundreds of thousands of entries. The PLCB continues to competitively price these products in comparison to other states, despite the exceptionally high demand.

FORWARD-LOOKING STRATEGY

The PLCB's pricing and product selection strategies will continue to focus on market-driven metrics while delivering on the agency's financial obligations to Pennsylvanians. It has been almost seven years since the passage of Acts 39 and 85 and the advent of flexible pricing. In that

time, processes related to cost negotiations and product pricing have become an integral element of the agency's business operations and our ongoing dialogue with suppliers.

Given the retail price increases implemented in January 2023, the PLCB does not currently plan any additional agency-initiated broad-based retail price adjustments during the remainder of the calendar year. However, inflation will likely continue to pressure suppliers to increase product acquisition costs, which will likely result in corresponding retail price adjustments on an item-by-item basis.

In 2022, the PLCB continued its practice of clearance pricing, as well as FW&GS store grand opening sales. For example, a 50%-off clearance sale was held on more than 3,300 wines, spirits and accessories both in stores and at FWGS.com. Clearance and grand opening sales—where customers are offered 10% off for three consecutive days at a specific location in conjunction with that store's opening—are mutually beneficial to our customers and the agency. Customers receive great deals and the PLCB benefits from greater store foot traffic and increased product sell-through. The agency plans to continue such sales in the future.

The PLCB's methodology for product pricing has allowed the agency to appropriately respond to market demand and negotiate with suppliers on an item-by-item basis rather than applying an inefficient one-size-fits-all approach. Despite the myriad of challenges during the past few years, the pricing reforms included in Acts 39 and 85 continue to help the agency provide value to our customers and meet our financial commitments to the commonwealth.